

**STATE OF NEW MEXICO
ENERGY, MINERALS AND NATURAL RESOURCES DEPARTMENT
OIL CONSERVATION DIVISION**

**IN THE MATTER OF THE HEARING
CALLED BY THE OIL CONSERVATION
DIVISION FOR THE PURPOSE OF
CONSIDERING:**

**CASE NO. 15185 (Reopened)
ORDER NO. R-13913-B**

**APPLICATION OF ARD ENERGY, LLC TO REOPEN CASE NO. 15185
PURSUANT TO THE PROVISIONS OF ORDER NO. R-13913 FOR THE
PURPOSE OF DETERMINING REASONABLE WELL COSTS, LEA COUNTY,
NEW MEXICO**

ORDER OF THE DIVISION

BY THE DIVISION:

This case came on for hearing at 8:15 a.m. on October 13, 2016 before Examiner Scott Dawson.

NOW, on this 7th day of March, 2017, the Division Director, having considered the testimony, the record and the recommendations of the examiner,

FINDS THAT:

(1) Due public notice has been given, and the Division has jurisdiction of this case and of the subject matter.

(2) COG Operating LLC ("COG") filed the original application in this case on July 9, 2014, seeking to compulsory pool the W/2 W/2 of Section 15, Township 17 South, Range 32 East, NMPM, in Lea County, New Mexico, ("the Unit") for the drilling of its then proposed Ivar the Boneless Federal Well No. 1H, a horizontal well to be completed in the Yeso formation.

(3) On October 16, 2014, the Division issued Order No. R-13913 granting COG's application for compulsory pooling and designating COG as operator of the subject well and the Unit. On May 26, 2015, the Division issued Order No. R-13913-A, changing the surface location of the subject well and changing the well name to Ivar the Boneless Federal Well No. 11H (API No. 30-025-42514; "the subject well"), but otherwise leaving Order No. R-13913 in effect.

(4) Division records reflect that the subject well was spudded on July 12, 2015, completed in August of that year, and has produced hydrocarbons each month commencing with September, 2015, and continuing to date of the hearing.

(5) On March 30, 2016, Ard Energy, LLC ("Ard"), a pooled party who elected to participate in the drilling of the subject well, filed the present application alleging that COG's actual well costs of drilling, completing and equipping the subject well exceeded reasonable costs, and asking the Division to determine reasonable well costs pursuant to Ordering Paragraph 11 of Order No. R-13913.

(6) Ard appeared at the hearing through counsel and presented documentary evidence and the testimony of a practical oil man and a petroleum engineer to the following effect:

(a) Ard owns a .053125 gross working interest in the Unit.

(b) Ard is not a party to an operating agreement covering the Unit, but elected to participate in the subject well as a pooled party.

(c) At the compulsory pooling hearing, COG presented an Authorization for Expenditures (the "original AFE") showing total estimated well costs of \$3,001,000.

(d) The original AFE was subsequently revised under date of February 11, 2015, ("the revised AFE") to reflect estimated well costs of \$3,403,000. Ard paid \$180,784.38 (its proportionate share of \$3,403,000), at the time it elected to participate.

(e) On February 17, 2016, COG filed with OCD its report of actual costs for drilling, completing and equipping the subject well in the total amount of \$4,170,604¹, exceeding estimated costs shown in the revised AFE by \$767,604. Based on this report, Ard's share of actual well costs would be \$221,563, exceeding the amount of estimated costs Ard paid when it elected to participate by \$40,779.

(f) After filing its statement of actual costs, COG continued to bill Ard for its share of additional expenses labeled on joint interest billings ("JIBs") as "intangible development costs" or "equipment costs" ("Additional Well Costs") attributed to the subject well. The total of Additional Well Costs shown on COG's joint interest statements August 31, 2016, was \$254,284; Ard' share thereof being \$13,509.

(g) In addition, COG's joint interest statements included \$503,601.77 in "lease operating costs;" Ard's share thereof being \$26,754.

¹ All figures in this order are rounded to the nearest whole dollar.

(h) The costs attributed to the subject well in COG's joint interest statements from inception through August 31, 2016, can be summarized as follows:

Summary of Estimated and Billed Well Costs

<u>Description</u>	<u>100%</u>	<u>Ard Share</u>
<u>Scheduled cost overruns:</u>		
Actual well costs filed with OCD on 2-17-16	\$4,170,604	\$221,563
Less: Estimated well costs per 2-11-15 AFE	(3,403,000)	(180,784)
Excess of scheduled actual well costs over estimated well costs	\$ 767,604	\$40,779
<u>Additional Well Costs per JIBs:</u>		
Total IDC + Equipment through 8-31-16	4,424,888	235,072
Less: Actual Costs filed 2-17-16	(4,170,604)	221,563
Additional Well Costs	254,284	13,509
<u>Operating Costs</u> billed from inception through 8-31-16	<u>503,602</u>	<u>26,754</u>
Total costs at issue	<u>\$1,525,490</u>	<u>\$81,042</u>

(i) Ard paid some of the additional costs billed, but then discontinued payment. COG offset amounts it claimed were due for unpaid expenses relating to the subject well against amounts COG owed Ard as proceeds of production from other wells.

(j) Actual well costs that exceeded the amounts on the revised AFE were unreasonable because the total well cost estimate of \$3,403,000 in the February 11, 2015 AFE was, according to Ard's engineering witness, "on the high side," and nothing in the well information that COG furnished indicated unusual events or conditions encountered during drilling that would justify large cost overruns.

(k) Actual title examination costs of \$215,336, for which only \$11,000 was budgeted, appeared to be excessive because of the extremely large overage and because the title opinion covered the entire W/2 of Section 15 and eight separate zones, whereas the Unit included only the W/2 W/2 and the Yeso formation.

(l) Reported actual costs included surface equipment and connections for three additional wells COG planned to drill on the subject unit. A prudent operator would not incur expenses to prepare for four wells prior to completion of the first one.

(m) The operating expenses reflected on the JIBs were excessive and unreasonable to the extent that they exceeded typical operating costs for this type of well, which Ard's engineering witness estimated as approximately \$5,400 per month of operation, or \$70,200 for the 13-month period covered by the JIBs..

(n) The reasonableness of many items included in COG's schedule of actual costs could not be ascertained without more detailed drilling reports and vendor invoices, which COG did not furnish.

(7) COG appeared at the hearing through counsel and presented documentary evidence and the testimony of a landman and a petroleum engineer to the following effect:

(a) The differences between estimated costs shown in the February 11, 2015 AFE and actual costs shown on the February 17, 2016 schedule filed with OCD can be summarized as follows:

<u>AFE line item</u>	<u>Actual Cost</u>	<u>Estimated Cost</u>	<u>Excess</u>
(i) Title Examination/Permit	\$215,336	\$ 11,000	\$204,336
(ii) Couplings, Fittings, Valves	218,934	36,500	182,434
(iii) Contract Labor	206,898	71,150	135,748
(iv) Heater Treater/Separator	175,182	29,000	146,182
(v) "Miscellaneous"	79,525	0	79,525
(vi) Other line items (excess)	19,379		19,379
Total	<u>895,875</u>	<u>147,650</u>	<u>\$767,604</u>

(b) Regarding the \$204,336 title examination cost overrun, COG's land witness testified that due to the complexity of title to the subject unit, (i) drilling any well thereon without examination of the subject 1930s federal oil and gas lease from inception as to all lands and formations would not have been prudent, and (ii) in view of those complexities the costs incurred were not unreasonable.

(c) The scheduled actual well costs of \$4,170,604.19 included cost of obtaining and installing surface production equipment for four wells contemplated on the Unit; whereas the estimated costs included only surface equipment then believed to be required for the first well.

(d) At the time of the hearing two additional wells had been drilled, and the fourth well was being drilled. Ard elected non-consent as to its interest in these additional wells.

(8) No other person appeared at the hearing or opposed Ard's Application.

The Division concludes as follows:

(9) The only issues now before the Division are the reasonableness of COG's actual well costs, including the Additional Well Costs, and if such costs are found to be

unreasonable, the amount of reasonable well costs. Order No. R-13913 provides, in Ordering Paragraph (11), that “[i]f there is an objection to actual well costs . . . , the Division will determine reasonable well costs after public notice and hearing.” Ordering Paragraph (12) allows the operator 60 days after such determination is made within which to reimburse a party who has paid an amount greater than its share of reasonable well costs. An accounting would be premature under this provision until at least 60 days after the Division determines actual well costs.

(10) The term “well costs” is defined in OCD Rule 19.15.13.8.B to include only costs of drilling, completing and equipping the well. Operating costs are not included. Although a pooled party’s liability for operating costs is also limited to those that are reasonable, Ard’s Application did not raise any issue concerning operating costs, nor did the notice of hearing in this re-opened case indicate any such issue. Accordingly, this Order should not include a determination of operating costs. Ard may present its complaints concerning operating costs in a subsequent application.

(11) Neither NMSA Section 70-2-17, nor Order No. R-13913, addresses the burden of proof in a proceeding to determine reasonableness of well costs. Accordingly, the Division concludes that the party filing an application bears that burden. To meet this burden, the applicant for a reasonable cost determination must identify particular line items in the operator’s schedule of actual well costs that it contends are unreasonable, and show what a reasonable amount would have been. If such evidence is offered, it then becomes the burden of the operator to justify the costs incurred.

(12) The Division is mindful of the testimony of Ard’s engineering witness that he could not opine as to the reasonableness of certain costs because COG refused to produce subpoenaed documents. However, since Ard did not file, and request a hearing on, a motion to compel production, no inference will be drawn from this circumstance.

(13) The gist of Ard’s case was that the well costs for the Ivar the Boneless Federal Well No. 11H were unreasonable because they substantially exceeded estimated costs.

(14) There is authority that in the oil and gas industry an AFE is only an estimate, and not a legally binding limitation on costs. *E.g. Cleverock Energy Corp. v. Trepel*, 609 F.2d 1358, 1362 (10th Cir. 1979). Hence inferences based on excesses, even substantial excesses, of actual costs over AFE costs cannot, alone, support a finding that actual costs were unreasonable.

(15) Ard’s engineering witness testified that drilling costs were not increasing during the relevant time, and that drilling reports and other available evidence failed to indicate unusual events that would justify cost overruns. However, this evidence is unpersuasive in view of evidence that most of the cost overruns involved title examination, surface production equipment and unspecified “contract labor” costs, not direct drilling costs.

(16) Title examination and curative costs on COG's schedule of actual costs amounted to \$215,336, exceeding estimated costs of \$11,000 by \$204,336. This amount was approximately 27% of the excess of scheduled actual costs over estimated costs. Ard's business and legal witness testified that title examination costs were, in his opinion, unreasonable because the drilling title opinion covered the entire W/2 of Section 15 and multiple formations, and was not limited to the Unit and the formation in which the well was completed. However, COG's land witness testified that the title to the subject oil and gas lease was so interconnected as to various lands and formations that it would not have been reasonable to drill the subject well in reliance on a more limited title opinion. Accordingly, actual title costs were not shown to be unreasonable.

(17) As to production equipment, it is undisputed that COG's schedule of actual costs included equipment and equipment-related costs for a four-well drilling program. Although the testimony diverged as to the reasonableness of this allocation, we find the allocation of 100% of such costs to the first well cannot be accepted as reasonable where a non-operator has a legal right to make a separate election as for each well.

(18) The evidence supports a conclusion that Items (ii)-(v) in the table of cost overruns in Finding Paragraph (7)(a) were equipment or equipment related. COG presented no evidence as to how much actually related to equipment or installations not necessary for the first well. Accordingly, only one-fourth of the scheduled cost overruns for those items, or \$ 135,972, should be included in reasonable well costs.

(19) Actual well stimulation costs were \$935,00. The original AFE included estimated stimulation costs of \$782,000. Comparing these numbers, Ard's witness testified that stimulation costs were unreasonable because such costs should not have exceeded the estimate by more than \$15,000 to \$20,000. However, that estimate was revised, in the final pre-drilling AFE, which Ard approved, to \$920,000. Actual costs of \$935,000 did not exceed this revised estimate by more than the amount that Ard's witness testified would be reasonable.

(20) Numerous other line items in the actual well cost schedule exceeded estimates by relatively small amounts, not sufficient, without more, to give rise to an inference that such costs were not reasonable.

(21) COG filed its schedule of actual well costs on February 17, 2016. Thereafter, COG billed Ard for additional well costs as shown in the table in Finding Paragraph 6(h).

(22) Ard offered no evidence of unreasonableness of any particular items of the subsequently billed well costs. Hence, the entire \$254,284 should be included in reasonable well costs.

(23) Reasonable well costs for the Ivar the Boneless Federal Well No. 11H should be determined as follows:

	<u>100%</u>	<u>Ard Share</u>
Scheduled Actual Well Costs	\$4,170,604	\$221,563
Additional Well Costs	<u>254,284</u>	<u>13,509</u>
Total actual well costs	\$4,424,888	\$235,072
<u>Less</u> , improperly allocated equipment costs	<u>543,899</u>	<u>28,895</u>
	\$3,880,989	\$206,177
<u>Plus</u> , 25% of improperly allocated equipment costs	<u>135,975</u>	<u>7,224</u>
REASONABLE WELL COSTS	<u>\$4,016,964</u>	<u>\$213,401</u>

IT IS THEREFORE ORDERED THAT:

(1) Pursuant to the application of Ard Energy, LLC and to Ordering Paragraph (11) of Order No. R-13913, the reasonable well costs for the drilling, completion and equipping of Ivar the Boneless Well No. 11H (API No. 30-025-42514), located 75 feet from the North line and 330 feet from the West line (Unit D) of Section 15, Township 17 South, Range 32 East, NMPM, Lea County, New Mexico, are hereby determined, for purposes Ordering Paragraphs (11) and (12) of Order No. R13913, as of August 31, 2016, to be \$4,016,964 (100%), or \$213,401 for Ard's 5.3125% share of the working interest.

(2) Order No. R-13913, as amended by Order No. R-13913-A, shall remain in full force and effect

(3) Nothing in this order shall be construed to preclude Ard Energy LLC from filing a separate application challenging the reasonableness of operating costs of the Ivar the Boneless Federal Well No. 11H.

(4) Jurisdiction of this case is retained for the entry of such further orders as the Division may deem necessary.

DONE at Santa Fe, New Mexico, on the day and year above designated.



STATE OF NEW MEXICO
OIL CONSERVATION DIVISION

DAVID R. CATANACH
Director